MEMORANDUM

HOUSE FISCAL AGENCY

DATE: March 27, 2003

TO: Mitch Bean, House Fiscal Agency Director

FROM: Rebecca Ross, Senior Economist
Jim Stansell, Economist

RE: Tax Loophole Closures Under the Executive Recommendation

This memorandum describes the revenue changes proposed in the executive recommendation to eliminating tax loopholes. Legislation has not been introduced, but the descriptions represent the HFA interpretation of the executive recommendation.

Tax Loophole Closures

The Fiscal Year (FY) 2003-04 Executive Budget defines a loophole as:

> a situation where individuals and organizations have found a way to circumvent the intent of the original statue and are not paying their fair share of the tax burden. By not paying their fair share, they are shifting the tax burden to other taxpayers. The goal is not to make citizens or businesses pay higher taxes but rather ensure that the state collects taxes that are rightfully owed.

The loophole closures are separated into five categories - income tax non-resident tax changes, single business tax (SBT) changes related to business form or filing status, limit out-of-state business tax shelters, eliminate unintended tax exemptions, and restore tax penalties. Table 1 depicts the estimated fiscal impact, as determined by the Department of Treasury, of the executive recommendation for tax loophole closures by General Fund/General Purpose (GF/GP) and School Aid Fund (SAF) for FY 2003-04. The FY 2003-04 estimated fiscal impact of the loophole closures would result in a revenue increase of $128.9 million - $108.7 million in GF/GP and $20.2 million in SAF.

Income Tax Nonresident Tax Changes

The executive recommendation includes three items that tax the income of nonresidents.

✓ Non-resident casino winnings. To establish tax parity between residents and non-residents, impose the same tax on the casino winnings of non-residents that would apply to Michigan residents.

✓ Non-resident business income earned in Michigan. All business income earned by a non-resident person while in Michigan will be taxed to the full extent provided by the United States Constitution. This provision applies mainly to gains from the sale of a part of a business.

✓ "Flow-through" business income paid to non-residents. "Flow-through entities" such as Limited Liability Corporations (LLCs), Limited Liability Partnerships (LLPs), and S Corporations with non-resident members, partners, and/or shareholders will be required to file a composite income tax return and pay the tax on the distributive income for their members, partners, and/or shareholders.

SBT Changes Related to Business Form or Filing Status

The executive recommendation includes five SBT changes that relate to the business form or filing status.

Include LLC member compensation in SBT small business credit calculation. In determining whether or not a an LLC is eligible for an SBT small business credit, the compensation of the members must be included. Under current law, a firm can receive an SBT small business credit contingent upon its gross receipts and levels of compensation. For example, an individual, partnership, or S Corporation is not eligible if any individual, any one partner, or any one shareholder receives more than $115,000 as a distributive share of adjusted business income. This would extent the same provisions to LLCs.

Include leased officer pay for SBT small business credit. In addition to the above provision, the compensation of officers of a company who are leased employees shall be used to determine the eligibility for an SBT small business credit.

Extend corporate officer tax liability provisions to LLC and LLPs. The Revenue Act (PA122 of1941) holds that if a corporation liable for taxes fails to file the necessary returns and/or pay the tax due, any of its officers having the control and/or responsibility of filing returns or making payments is personally liable. The executive recommendation would extend this treatment to include persons who are members, managers, or in similar positions in a LLP or LLC.

Prevent shifting of unrealized business losses and credits from "flow-through" and subsidiary entities. This occurs when a trust or LLC that has a loss carryforward is wholly owned by another business which files a consolidated return and attempts to use the loss carryforward of the LLC to offset its own tax liability. The executive recommendation would eliminate this contingency.

Prohibit exclusion of inter-company sales in SBT apportionment. The SBT apportionment formula is 5% property, 5% payroll, and 90% sales. Thus, the overall proportion of business activity taxable in Michigan is the sum of the percent of a firm's property located in Michigan times 5%, the percent of total payroll attributable to Michigan time 5%, and the percent of sales occurring in Michigan times 90%. One method used to alter the outcome is for a multi-state firm to exclude inter-company transfers (or sales), which effectively lowers the sales (and overall) percent of business activity in Michigan. The executive recommendation would eliminate intra-company transfers from this calculation.

Limit Out-of-State Business Tax Shelters

The executive intent of the following three items is to limit out-of-state business tax shelters.

Create "affiliate nexus" standard for nonresident affiliates. Nexus is an economic presence within the state that establishes tax liability. Nexus is established by certain business activities or real and tangible personal property held in the state. The "affiliate nexus" standard would disregard the legal business form in opposing nexus for nonresident affiliate companies without a physical presence in Michigan. This change would apply the SBT to out-of-state affiliates that are essentially doing the same thing as an in state company.

Include out-of-state affiliates for small business credit in SBT. The calculation of the small business credit would include out-of-state businesses under the control of a Michigan business.

This change, which would be consist with the current law treatment of the statutory exemption, would reduce the number of businesses eligible to claim the credit and the credit amount.

Prohibit deduction for out-of-state gains paid to Michigan business in SBT. Business income would only be deductible if the out-of-state entity is taxable in Michigan.

Eliminate Unintended Tax Exemptions

The executive intent of the following three items is to eliminate unintended tax exemptions.

Real Estate Transfer Tax Avoidance. Separating the purchase of real property from the purchase or construction of a building or home when the purchase agreement for the property requires the purchaser to utilize certain builders. This change would ensure that the real estate transfer tax is consistently applied to both the land and the home.

Severance Tax "in-lieu-of-other taxes". The severance tax, which was adopted in 1949, is a tax on the gross cash market value of oil and gas severed. The executive recommendation specifies that the severance tax would be in lieu of other property taxes and not in lieu of all other taxes. This change would result in an increase of SBT and income tax revenue.

Insurance Tax "in-lieu-of-other taxes". Modify SBT provision to ensure that insurance companies are subject to sales and use tax as opposed to the SBT in lieu of other taxes. This change would primarily be an use tax issue to eliminate the incentive for insurance companies to purchase tangible personal property from out of state.

Restore Tax Penalties

Public Act 657 of 2002 reduced certain taxpayer penalties for failure to remit a tax with a negotiable remittance, failure for certain income tax withholding taxpayers to comply with a schedule of deposits as prescribe in statute, and failure to file during a tax amnesty period. The executive recommendation would restore the penalty provisions, which were effective prior to PA 657 of 2002.

Table 1
Executive Recommendation Tax Loophole Closures for FY 2003-04
millions of dollars

	GF/GP	SAF	Total	
Income Tax Nonresident Tax Changes				
Nonresident casino winnings	6.5	2.3	8.8	- enacted
Nonresident business income earned in MI	4.5	1.5	6.0	- enacted
"Flow-through" business income paid to nonresidents	1.5	0.5	2.0	- enacted
Subtotal	12.5	4.3	16.8	
SBT Changes Related to Business Form or Filing Status				
Include LLC pay in small business credit calculation	4.5	0.0	4.5	
Include leased officer pay for small business credit	2.0	0.0	2.0	
Extend officer tax liability provisions to LLCs and LLPs	2.0	0.0	2.0	- enacted
Prevent shifting of certain unrealized losses and credits	10.0	0.0	10.0	
Include inter-company sales in sales factor	10.0	0.0	10.0	
Subtotal	28.5	0.0	28.5	
SBT & Use Tax - Limit Out-of-State Business Tax Shelters				
Create "affiliate nexus" standard for nonresident affiliates				
SBT	10.0	0.0	10.0	
Use	10.0	5.0	15.0	
SBT - include out-of-state affiliates for small business credit	4.0	0.0	4.0	
SBT - prohibit deduction for out-of-state gains paid to MI business	8.6	0.0	8.6	
Subtotal	32.6	5.0	37.6	
Eliminate Unintended Tax Exemptions				
RET - impose tax on transfers designed to avoid tax	0.0	8.0	8.0	
Severance Tax "in-lieu-of-other taxes"				
SBT	5.0	0.0	5.0	
Income Tax	8.1	1.9	10.0	
Insurance Tax "in-lieu-of-other-taxes"				
Use	2.0	1.0	3.0	
Subtotal	15.1	10.9	26.0	
Restore Tax Penalties				
Eliminate penalty reduction enacted in December 2002	20.0	0.0	20.0	
Total	**108.7**	**20.2**	**128.9**	

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